

UNITED STATES

ROBERT W. MULLEN, JR.*

MICHAEL J. SIMON**

1. SEC REGISTRATION REQUIREMENTS AND THE NATURE OF THE PRIVATE PLACEMENT EXEMPTION

The Securities Act of 1933¹ (the "Securities Act") generally requires all offers and sales of securities to be registered with the U.S. Securities and Exchange Commission (the "SEC"). However, this requirement does not apply to securities exempted from the Securities Act or to specified exempted transactions. One such exemption is the "private placement" exemption in section 4(2) of the Securities Act for transactions not involving a public offering.²

The statutory private placement exemption, and the SEC rules adopted pursuant to that exemption, are the sole means for conducting private offerings in the United States under the Federal securities laws. However, other exemptions available under the Securities Act, while not specifically addressing private placements, by their nature may provide exemptions for certain types of limited offerings.

2. PRIVATE PLACEMENT EXEMPTIVE PROVISIONS

2.1. *Statutory Provisions*

The private placement exemption is contained in section 4(2) of the Securities Act, which provides that the SEC registration requirements do not apply to "transactions by an issuer not involving any public offering."³ While the SEC at one time provided interpretive assistance regarding section 4(2), it does not do so any longer. Thus, practitioners must

* Partner, Milbank, Tweed, Hadley & McCloy, New York, New York. A.B. 1977, University of Pennsylvania; J.D. 1980, Fordham University.

** Senior Attorney, Milbank, Tweed, Hadley & McCloy, New York, New York. A.B. 1975, University of Rochester; J.D. 1978, University of Pittsburgh.

¹ Securities Act of 1933 (Securities Act), 15 U.S.C. §§ 77a-77aa (1988).

² Securities Act, *supra* note 1, § 77d(2).

³ *Id.*

rely on judicial and previous administrative determinations when applying the private placement provisions.

In considering whether section 4(2) is available, a central issue is whether offerees need the protection afforded by the Securities Act. That is, are the offerees of the nature that they have access to the same kind of information that would be available pursuant to registration, thus allowing them to fend for themselves? Other relevant factors include the manner of the offering (including the procedures employed to assure that there is no redistribution of the securities being offered) and the number of offerees. There is no SEC filing requirement under section 4(2).

In practical terms, section 4(2) is applied by limiting offers and sales to a controlled group of institutional and other sophisticated investors. There also may be prepared a "private placement memorandum," somewhat similar to a prospectus for a registered offering that provides disclosure tailored for the type of issuer and the types of investors solicited. Access to this offering material is strictly controlled to preserve the non-public nature of the offering. To prevent subsequent unauthorized resales of privately-placed securities, there often are legends on the certificates and agreements by placement agents and purchasers not to resell securities absent registration under the Securities Act or the availability of an exemption from registration.

The SEC's recent adoption of Rule 144A under the Securities Act has led to some modifications of these traditional limitations on resales.⁴ As discussed below, Rule 144A permits the resale of certain privately-placed securities among large institutions known as "qualified institutional buyers."⁵ Since the traditional resale restrictions are inconsistent with an SEC-sanctioned resale market, legends and other resale restrictions now acknowledge the potential for sales into the Rule 144A market.

Moreover, although Rule 144A on its face only addresses resales, the rule has had a direct effect on the practices governing many initial private placements. Specifically, in some private placements, issuers now limit initial sales to

⁴ 17 C.F.R. § 230.144A (1992).

⁵ *Id.* § 230.144A(a)(1).

qualified institutional buyers, although a broader distribution may well be permissible under section 4(2). By limiting the distribution to qualified institutional buyers, issuers and their counsel believe that they can forsake some of the traditional private placement resale restrictions by relying on the special status of qualified institutional buyers not to resell securities absent registration under the Securities Act or pursuant to an available exemption from registration.

2.2. SEC Rulemaking

As a supplement to the general private placement exemption available under the statute, the SEC has adopted "Regulation D," a "safe harbor" under section 4(2) that contains a series of rules providing a non-exclusive method for issuers to effect a private placement.⁶ While there are special eligibility requirements for offerings of less than one million dollars⁷ and five million dollars,⁸ for offerings of unlimited size the requirements include:

- While there can be an unlimited number of "accredited investors," there can be no more than 35 other purchasers of the securities. "Accredited investors" include certain specified institutions, as well as high net worth individuals;⁹
- Each purchaser who is not an accredited investor must have sufficient knowledge or experience to evaluate the merits of the offering, or the issuer must reasonably believe this to be the case. The issuer must provide such persons with certain specified information;¹⁰ and
- There can be no general solicitation or advertising.¹¹

In addition to the eligibility requirements, Regulation D also contains an SEC filing requirement. Specifically, the

⁶ *Id.* §§ 230.501 to .506.

⁷ *Id.* § 230.504.

⁸ *Id.* § 230.505.

⁹ *Id.* § 230.506.

¹⁰ *Id.*

¹¹ *Id.* § 230.502(1).

issuer must file a Form D with the SEC within fifteen days of the first sale.¹² The form discloses information on the issuer, the size and nature of the offering, the number of investors and the use of the proceeds.¹³

2.3. *Limitations of the Private Placement Exemption*

Regardless of whether the private placement is effected under section 4(2) or Regulation D, there are a number of limitations on the exemption. Of most importance, both section 4(2) and Regulation D are exemptions only from the registration provisions of the Securities Act.¹⁴ They do not provide exemptions from most anti-fraud provisions of the Federal securities laws.¹⁵

For example, section 12(2) of the Securities Act provides for liability if any written or oral statement made in connection with an offer or sale of securities includes an untrue material fact or omits to state a material fact necessary to make other statements not misleading.¹⁶ This applies to exempt, as well as registered, offers and sales. However, there is a "due diligence" defense to this liability if the offeror can show it "did not know, and in the exercise of reasonable care could not have known, of such untruth or omission."¹⁷ A plaintiff bringing a successful action under this section can rescind the purchase or can sue for damages if he no longer owns the security.¹⁸

In addition, section 10(b) of the Securities Exchange Act of 1934¹⁹ (the "Exchange Act") and Rule 10b-5 thereunder also provide for general liability for untrue statements of material facts and for omitting material facts necessary to make other statements not misleading.²⁰ Similarly, section 17(a) of the Securities Act prohibits fraudulent devices in connection with

¹² *Id.* § 239.500(a).

¹³ *Id.*

¹⁴ *See, e.g.*, 17 C.F.R. § 230.501, preliminary note 1.

¹⁵ *Id.*

¹⁶ Securities Act, *supra* note 1, § 77l.

¹⁷ *Id.* § 77l(2).

¹⁸ *Id.*

¹⁹ Securities Exchange Act of 1934 (Exchange Act), 15 U.S.C. §§ 78a-78kk (1988).

²⁰ *Id.* § 78j; 17 C.F.R. § 240.10b-5 (1992).

the offer or sale of securities.²¹

Section 11 of the Securities Act is an anti-fraud provision which does *not* apply to private placements.²² Section 11 provides for liability *only* for false registration statements and is inapplicable to private placements for which no registration statement is filed.²³

As with the anti-fraud provisions of the Federal securities laws, the private placement exemptions do not provide exemptions from the Investment Company Act of 1940 (the "Investment Company Act").²⁴ Due to the broad definition of "investment company" under that act, foreign banks, insurance companies and their holding companies, certain finance companies and special purpose subsidiaries, and other types of institutions can be considered investment companies.²⁵ Under SEC interpretations, if there will be more than 100 beneficial owners of securities (not including beneficial owners of short-term paper) of an issuer resident in the United States after the private placement, an issuer deemed to be an investment company must either register under the Investment Company Act or be exempt from registration.²⁶ However, because it is currently impracticable for a foreign investment company to register with the SEC, foreign investment companies must achieve an exemption from registration. The SEC recently adopted a rule excluding foreign banks and foreign investment companies from the definition of "investment company",²⁷ thereby negating the need of such entities either to register under the Investment Company Act or to obtain an exemption from registration.

The private placement exception also does not provide relief from a number of Exchange Act regulatory provisions. For example, persons acquiring five percent of a class of equity securities registered under the Exchange Act must report such

²¹ Securities Act, *supra* note 1, § 77q(a).

²² *Id.* § 77k.

²³ The Form D filing requirement for private placements is not a registration statement.

²⁴ Investment Company Act of 1940 (Investment Company Act), 15 U.S.C. §§ 80a-1 to 80a-64 (1988).

²⁵ Investment Company Act, *supra* note 24, § 80a-3.

²⁶ *Id.* §§ 80a-6 to 7.

²⁷ 17 C.F.R. § 270.3a-6 (1992).

ownership to the SEC, even if the ownership was acquired in a private placement.²⁸ Similarly, corporate insiders of U.S. issuers (but not non-U.S. issuers) must report trading activity on a monthly basis in securities registered under the Exchange Act and are also subject to certain short-swing profit limitations.²⁹ These regulatory provisions apply notwithstanding the fact that a given transaction qualifies as a private placement.

A final limitation on the scope of the private placement exemption concerns state law. Specifically, notwithstanding compliance with the private placement requirements under the Securities Act, the various states, the District of Columbia and other territories have their own securities laws that issuers must consider. While there is generally no specific parallel to section 4(2), offers and sales of securities made to institutional investors or to a limited number of purchasers are generally exempted from state registration requirements.³⁰ In addition, in most jurisdictions the Uniform Limited Offering Exemption ("ULOE") is available for offerings and sales made pursuant to Regulation D.³¹

2.4. *Integration of Private Placements with Foreign Offerings*

The SEC historically has permitted issuers to conduct a non-U.S. offering (whether public or private) and not integrate that offering with a U.S. private placement. The SEC initially adopted this "non-integration" position in an informal ruling in 1964,³² and more recently affirmed this position in 1990 when the SEC updated its policies governing the exemptions from registration for offerings conducted outside the United States through the adoption of Regulation S under the Securities Act.³³

²⁸ Exchange Act, *supra* note 19, § 78m(d).

²⁹ *Id.* § 78p; 17 C.F.R. §§ 240.16a-1 to 16c-4 (1992).

³⁰ UNIF. SECURITIES ACT § 402(6)(8)-(9) (1985), 1 Blue Sky L. Rep. (CCH) ¶ 5642, at 1675.

³¹ *Id.*

³² Registration of Foreign Offerings by Domestic Issuers, Securities Act Release No. 4708, 29 F.R. 9828, [1964 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 1361 (July 9, 1964).

³³ 17 C.F.R. § 230.901 to .904 (1992).

2.5. Availability of Other Statutory Exemptions

In addition to the private placement exemptions, issuers may be able to rely on other statutory or SEC-adopted exemptions. For example, there is an exemption for the sale of "commercial paper," defined to include indebtedness arising out of "current transactions" with a maturity not exceeding 270 days.³⁴ In addition, the SEC has adopted Regulation A which provides a conditional exemption for offerings of no more than \$1.5 million.³⁵

3. RESALE OF PRIVATELY-PLACED SECURITIES

No provision of the Securities Act specifically provides an exemption for the resale of privately-placed securities (commonly referred to as "restricted securities"). However, notwithstanding the lack of a specific provision, the securities bar initially developed the concept that is widely referred to as the "section 4(1½) exemption." This "exemption" is a combination of an exemption for sales by persons other than an issuer, underwriter or dealer (in section 4(1) of the Securities Act) and the section 4(2) private placement exemption available to issuers.³⁶ Under this approach, resales of restricted securities are generally made in the same manner as initial private placements by issuers.³⁷ While the SEC has never officially sanctioned this market, neither has it formally objected to it.

In a partial codification of the "section 4(1½) exemption," in 1990 the SEC adopted Rule 144A under the Securities Act.³⁸ As mentioned above, this rule allows for private resales of certain restricted securities among "qualified institutional buyers," as generally defined to include institutions that have assets of at least \$100 million invested in securities.³⁹ While the scope of the exemption is somewhat more limited than that in the "section 4(1½) exemption," the

³⁴ Exchange Act, *supra* note 19, § 78c(3).

³⁵ 17 C.F.R. § 230.254 (1992).

³⁶ Securities Act, *supra* note 1, §§ 77d(1) to d(2).

³⁷ See Report *The Section '4(1½)' Phenomenon: Private Resales of 'Restricted' Securities*, 34 BUS. LAW. 1961 (July 1979).

³⁸ 17 C.F.R. § 230.144A (1992).

³⁹ *Id.* § 230.144A(a)(1)(i).

application of the exemption is more straightforward since it eliminates the need for any significant documentation.

4. MARKET REGULATION ISSUES

4.1. *Broker-Dealer Registration*

The Exchange Act requires all brokers and dealers engaged in the securities business in the United States to register with the SEC, regardless of whether such broker-dealers have a permanent place of business in the United States.⁴⁰ There is no exemption for broker-dealers engaged solely in the private placement market. Thus, all persons engaged in the business of buying and selling privately-placed securities must be registered with the SEC as broker-dealers unless some specific exemption from registration is available. Under SEC rules, all broker-dealers registered with the SEC must have a specified level of net capital and must meet certain other requirements imposed by the SEC and the U.S. "self-regulatory organizations," such as the stock exchanges and the National Association of Securities Dealers, Inc.⁴¹

4.2. *Trading During a Distribution*

SEC Rule 10b-6 and certain related rules (the "market regulation rules") significantly limit the ability of persons participating in a distribution (i) to bid for or purchase securities during a "distribution," or (ii) to attempt to induce any person to purchase securities during a "distribution."⁴² The SEC's definition of "distribution" includes all offerings "whether or not subject to registration under the Securities Act" that can be distinguished from ordinary trading "by the magnitude of the offering and the presence of special selling efforts and selling methods."⁴³

Despite this broad definition of "distribution," traditionally it had been assumed that a private placement was not a "distribution." However, following the adoption of Rule 144A,

⁴⁰ Exchange Act, *supra* note 19, § 78o(a); 17 C.F.R. § 240.15a-6 (1992).

⁴¹ See, e.g., 17 C.F.R. § 240.15(c)(3)-(3) (1992).

⁴² *Id.* § 240.10b-6.

⁴³ *Id.* § 240.10b-6(c)(5).

the SEC staff informally took the view that private placements of securities intended for resale in the Rule 144A market may be "distributions." The SEC initially provided limited relief from the application of the market regulation rules on a case-by-case basis.

In April, 1991, the SEC granted a blanket exemption from the market regulation rules for certain activities conducted during private distributions into the Rule 144A market.⁴⁴ This exemption applies only to distributions of foreign securities where the principal market for the securities are outside the United States.⁴⁵ The issuer of the securities must have a three-year operating history and voting stock with an aggregate market value of at least \$150 million.⁴⁶ Moreover, transactions are exempt only if they occur on the International Stock Exchange (on SEAQ and SEAQ International), the Montreal Exchange, or the Paris, Tokyo or Toronto Stock Exchanges.⁴⁷ Finally, the terms of the exemption require persons relying on this exemption to provide the SEC staff with certain information on the distribution.⁴⁸ For transactions outside this blanket exemption, the SEC still may be willing to give case-by-case exemptions.

⁴⁴ See Securities Industry Association, SEC No-Action Letter, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,669 (Apr. 25, 1991).

⁴⁵ *Id.*

⁴⁶ *Id.*

⁴⁷ *Id.*

⁴⁸ *Id.*